

## Introduction

Capital serves many purposes, and the level and composition of capital a company holds is an important measure of its overall financial health, as well as the health of its subsidiaries. Holding companies must ensure that they have sufficient capital to support their underlying risks. Capital provides a holding company with a buffer in times of poor operating performance, maintains public confidence in the holding company, and supports growth. Raising capital for the enterprise often takes place at the holding company level. An efficient capital structure is one that combines the appropriate mix of equity and debt to fund an enterprise's strategic plan and enhance financial performance without unduly burdening subsidiaries, particularly the thrift. Hybrid instruments add one more option to the capital funding mix. A hybrid instrument is generally a security that has both equity and debt characteristics.<sup>1</sup>

The scope and complexity of banking and other financial services, particularly the array of financial products, makes it important to evaluate capital based on a company's overall risk profile. High capital ratios alone do not indicate capital adequacy, especially when an organization is involved in risky activities or capital arbitrage techniques. Organizations use internal processes to assess risks and to ensure that capital, liquidity, and other financial resources are sufficient in relation to their risk profile. The sophistication and level of detail of a holding company's capital management techniques varies based on the complexity and size of the enterprise. You should request the holding company's support and analysis for its capital management strategies in the pre-examination response kit or during the course of the examination.

OTS-regulated holding companies should have a prudential level of capital to support their risk profile. OTS does not impose consolidated or unconsolidated regulatory capital requirements on thrift holding companies. As a result, examiners must consider all aspects of an organization's risk profile to determine if capital is adequate on a case-by-case basis. In the capital component you will review:

OTS-regulated holding companies should have a prudential level of capital to support their risk profile.

- The level of debt/hybrid instruments and the ability of the holding company to service its obligations.
- The quality and quantity of capital using several different measures as well as the availability of capital and the ability of the holding company to raise new capital if needed.
- The holding company's dividend practices.

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<sup>1</sup> [Appendix A](#) provides an overview of hybrid capital instruments.

## CAPITAL SUFFICIENCY/RISK ANALYSIS

### Assessing the Overall Risk Profile

The need to assess overall risk is inherent in each component of the holding company examination. This process starts by completing the Risk Classification Checklist in the [Administrative Program, Section 710](#). The examination team then refines and updates this preliminary risk assessment as its understanding of the holding company evolves during the examination. Many of the conclusions that you will make in addressing the capital strength of a holding company will be dependent on findings in other examination components. For example, the following questions help assess the overall risk profile of a holding company's capital structure. In many cases, you will need to review other sections of this handbook to properly address them:

#### *Organizational Structure Issues*

- What is the nature and level of risk associated with the holding company's activities?
- Is the volume or term of intra-group transactions cause for regulatory concern?
- Are levels of exposures or concentrations acceptable?

#### *Risk Management Issues*

- Does management effectively identify and control major risks?
- Are internal controls and audit procedures reliable?
- Are board and senior management oversight, policies and limits, risk monitoring procedures, reports and management information systems effective?

#### *Earnings Issues*

- Is the overall financial condition of the holding company deteriorating, stable, or improving?
- Does the holding company have sufficient earnings to support dividends?

#### *Other Capital Related Issues*

- Do the holding company and other affiliates have off-balance sheet contracts or activities (with explicit or implied recourse) that result in a higher degree of risk exposure than is apparent from the balance sheet?
- Are there any terms, conditions, or covenants in the holding company's or other affiliate's securitization documents or securities prospectuses that could trigger early amortization, the transfer of servicing, or other events?

- How does the holding company capital level compare to its peers?
- How do ratings and other industry analysts perceive the holding company?
- Has the holding company issued equity securities with terms that could adversely affect its ability to raise capital by issuing additional shares?

## EVALUATING DEBT AND HYBRID INSTRUMENTS

Financial leverage is the use of debt to supplement the equity in a company's capital and funding structure. Debt includes borrowings with specific terms and excludes deposits and transactional liabilities. To analyze the holding company's overall use of leverage, you should also include trust preferred securities or similar hybrid instruments that possess both debt and equity characteristics.

From the perspective of management and stockholders, debt/hybrid instruments can represent a favorable financial tool as the owners only need to provide a small portion of the total financing, and the lenders will bear much of the financial risk. This allows the existing owners to maintain control with a limited investment at stake and, assuming the proceeds are reinvested at a positive spread, the earnings generated will increase the overall Return on Equity (ROE). Some companies use debt/hybrid instruments for the acquisition of other entities.

Although the judicious use of leverage is a favorable financial management technique, you should be alert to the following pitfalls:

- Leverage may pressure management to produce short-term revenues to service obligations resulting in greater risk taking.
- Highly leveraged firms are more susceptible to losses during economic downturns in the general economy or in specific industries. These losses compound because declining financial condition increases borrowing costs. As debt or hybrid securities mature, the company must renew them, often at higher interest rates.
- The use of leverage reduces management's flexibility in making future decisions; lenders may impose the following types of covenants that could adversely affect the thrift:
  - Limits on future issues;
  - Provisions to accelerate repayment in certain circumstances;
  - Limits on dividend payments; or
  - Specific constraints on operating ratios.

You must assess the role of leverage within the consolidated holding company operations/financial structure. You should also assess the actual and potential affect such leverage may have on its operations, or on the operations of the thrift. Implicit in such analysis, you need to identify the extent the holding company utilizes debt or hybrid instruments to capitalize/fund the thrift's operations, and the degree to which the parent relies upon the thrift to provide cash flow to service obligations resulting from debt or hybrid issuances.

Holding company boards of directors should develop prudent capital management plans before undertaking financing activities in the marketplace. Otherwise, they may be implementing a funding strategy that creates financial burdens. You should review the way the holding company deploys the proceeds of such financings and services such obligations. You will also need to determine if the holding company is overextended given its financial characteristics.

Holding company boards of directors should develop prudent capital management plans before undertaking financing activities in the marketplace.

You should consider the following questions:

- What is the ratio of holding company debt as a percentage of tangible capital?<sup>2</sup>
- What is the ratio of holding company hybrid instruments as a percentage of tangible capital?
- Is the level of debt/hybrid instruments rising?
- What investments or activities do the debt/hybrid instruments fund?
- What effect could the terms, conditions, or covenants have?
- What is the maturity schedule for debt or hybrid instruments' effect on liquidity?
- What is the level of interest expense?
- Is interest expense a significant percentage of recurring income?
- What is the primary source of funds to pay interest or principal payments?
- If the holding company will repay debt/hybrid instruments with an additional issuance, or the interest rate on the instrument is adjustable, what is the interest rate risk?
- What ratings on its debt or hybrid securities has the holding company received from nationally recognized credit organizations?

*There are several ratios that you may use to assess these factors.*

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<sup>2</sup> Tangible Capital = Capital minus intangible assets.

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Calculate the parent company leverage by looking at the debt to capital ratio. Include trust preferred or other hybrid instruments in the numerator with long-term debt:

$$\text{Debt to Capital Ratio} = \frac{\text{Long-Term Debt}}{\text{Tangible Capital}}$$

A holding company with a low debt to capital ratio will generally have greater access to the capital markets.

There are no “bright line” thresholds for categorizing highly leveraged operations, and the company’s earnings power primarily dictates the acceptable level of long-term obligations. Accordingly, you should focus your review on the ability of the company to generate cash flow to meet its fixed debt service. The higher the debt ratio, the more attention you should focus on holding company cash flow needs and earnings power. You should be sensitive to long- and short-term trends and management’s plans for using leverage.

You should also compute the total debt to equity ratio on a book and market value basis including trust preferred securities or other hybrid instruments with total debt in the numerator.

$$\text{Total Debt to Equity Ratio at Book Value} = \frac{\text{Total Debt at Book Value}}{\text{Equity at Book Value}}$$

$$\text{Total Debt to Equity Ratio at Market Value} = \frac{\text{Total Debt at Book Value}}{\text{Equity at Market Value}}$$

If the market value of equity is higher than the book value, the market value ratio will be lower than the book value ratio. This indicates a favorable market perception and the ability to raise capital at an attractive price. However, if the market value of equity is lower than the book value, the market value ratio will exceed the book value ratio, indicating the market will only provide capital at a discount to book value.

Note: For holding companies with significant nonthrift operations, the ratio of debt to total assets may be more meaningful. This would be especially true for holding companies involved in industries with a high percentage of fixed assets. (Such debt should be long-term to match the maturity of the assets acquired.) Ratios over ten percent may require follow-up. You should also compare the ratios to the holding company’s peers.

Another important step in analyzing parent company leverage is calculating the debt leverage ratio. Include trust preferred securities along with long-term debt in the numerator and denominator.

$$\text{Debt Leverage Ratio} = \frac{\text{Long-Term Debt}}{\text{Long-Term Debt plus Capital}}$$

A lower ratio signifies less exposure to loss when the company’s performance is poor, but also a lower return on equity when performance is good.

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*Simple versus Double Leverage*

The parent company may advance the proceeds of long-term debt or hybrid instruments to the thrift as debt or equity. Simple leverage exists when the holding company advances the proceeds as debt. Such debt should have repayment terms matching those of the holding company, and the thrift should service it from its current earnings. Double leverage exists when the holding company invests funds it obtains from debt or hybrid instrument proceeds into the thrift subsidiary as equity. Increasing the capital base of the thrift allows the thrift to increase its borrowings, thereby compounding the original holding company debt and resulting in higher consolidated leverage. In this situation, thrift revenues must be sufficient to service both levels of debt because typically the parent will rely upon dividends from the thrift subsidiary to fund its debt service requirements.<sup>3</sup> This can generate substantial pressure on the thrift to maintain its earnings to support future dividend payments, thereby increasing the temptation for the thrift to engage in higher risk operations.

Within complex operations, double leverage will not always be evident, as holding companies may not directly allocate parent level debt/hybrid instruments to provide equity in the thrift. You can use the double leverage ratio as a proxy to identify the role of double leverage:

$$\text{Double Leverage Ratio} = \frac{\text{Thrift \$ Equity}}{\text{Holding Company \$ Equity}}$$

Higher ratios or a trend of increasing ratios can indicate the existence or growth of double leverage in the holding company/thrift relationship. A ratio of 100 percent indicates that there is no double leverage in the organization, while a ratio of 125 percent indicates that the thrift derived 20 percent of its equity capital from sources other than parent equity investments. You should review the impact of double leverage on both the holding company and the thrift.

You should also identify when nonthrift subsidiaries of highly leveraged holding companies experience operating problems. Even when the holding company does not advance debt/hybrid instrument proceeds to the thrift, the parent may rely on the thrift for cash flow. This can result in the parent imposing a more aggressive or high risk operating philosophy upon the thrift to generate near term earnings to support higher dividends, management fees, or tax sharing payments.

If you determine that any further leveraging of the holding company poses a risk to the stability of the holding company or the thrift, you must immediately advise the Regional Director. It may be appropriate to require the holding company to provide specific information on its capital planning and allocation process or notice before incurring, renewing, or rolling over any debt or hybrid securities with debt-like characteristics. Such action may be most appropriate for holding companies:

- Whose subsidiary thrift institution has a composite CAMELS rating of 3, 4, or 5;
- That have a holding company composite rating of 3, 4, or 5; or

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<sup>3</sup> Capital distributions must be within the limits prescribed by 12 CFR 563, Subpart E (563.140 – 563.146).

- That would cause supervisory concern by issuing additional debt.

## QUALITY AND AVAILABILITY OF CAPITAL

Capital provides a secondary source of financial protection for the holding company if operating capacity is insufficient. A holding company that has capital does not necessarily have sufficient cash flow to meet contractual obligations when they are due. Capital can provide cash only if the holding company can sell selected assets, use the capital to secure new debt, or issue new equity. A particular capital position can be a function of a company's accounting practices, and you should not view capital as a proxy of a company's financial health. Accounting standards are often assumption driven and aggressive accounting assumptions can overstate the value of assets and shield a company's true capital position.

OTS typically considers three capital measures in determining thrift holding company capital sufficiency:

### GAAP Equity

Before you can calculate any relevant quantitative capital measures, you must determine the GAAP total equity of the holding company. GAAP total equity represents the aggregate of holding company equity, including all subsidiaries, after the elimination of intercompany items. The holding company must compute total equity in accordance with GAAP, or some other approved regulatory accounting for functionally or foreign regulated affiliates. For functionally or foreign regulated affiliates, determine if there are any agreements or conditions imposed that would require the holding company to devote financial resources (including capital contributions) to that entity. If such agreements or conditions exist, determine what effect they could ultimately have on other subsidiaries in the enterprise, including the subsidiary thrift.

Holding companies report GAAP equity on their financial statements in accordance with generally accepted accounting principles (GAAP). OTS does not adjust this number, which companies often express as a percentage of consolidated total assets. You must review GAAP equity relative to risk to accurately assess a holding company's capital adequacy.

### Tangible Capital

Tangible capital is a more conservative measure than GAAP equity. You derive tangible capital by deducting intangible assets from GAAP equity. In banking organizations, mortgage servicing rights are often the largest intangible asset. You may express tangible capital as a percentage of tangible assets (consolidated total assets minus intangible assets).

### Proxy Regulatory Measure

Banking regulators may impose regulatory capital levels that rely on additions or deductions from GAAP equity. Other functional or foreign regulators may also impose regulatory capital measures that rely on adjusting a common capital calculation to meet regulatory requirements. This measure becomes

less helpful for diversified holding companies that engage in financial and commercial activity, which have a much different balance sheet than monoline financial companies. Nevertheless, such an analysis can lead to important findings. OTS considers regulatory conventions, including the thrift and the bank holding company regulatory capital framework, when appropriate for its assessment of the holding company's financial condition.

Although savings and loan holding companies (SLHCs) are not subject to an explicit uniform minimum regulatory capital requirement, if a thrift holding company's activities are mostly banking-related, OTS performs a proxy regulatory capital calculation. Calculating a regulatory proxy facilitates comparison with bank holding company peers. OTS calculates the capital level by including or deducting certain balance sheet items to create an approximation of a Tier 1 core capital calculation. You should calculate a proxy using the formula below:

#### Proxy Formula

<b>Tier 1</b>	<b>Numerator Calculation</b>
Proxy	
HC630	Consolidated HC Total Equity
HC620	<b>Plus</b> Minority Interests <sup>4</sup> (see discussion below on restricted elements)
HC670	<b>Plus</b> Trust Preferred Instruments (see discussion below on restricted elements)
HC655	<b>Minus</b> Intangible Assets (Nonmortgage Servicing Assets and Others)
	<b>Denominator Calculation</b>
HC600	Consolidated Total Assets
HC655	<b>Minus</b> Intangible Assets (Nonmortgage Servicing Assets and Others)

There are a few points to note with regard to the proxy calculation:

**Nonfinancial equity investments.** The proxy calculation does not deduct nonfinancial equity investments to recognize the difference in the scope of permissible activities for SLHCs. Depending on the risk and amount of nonfinancial investments, you may choose to exclude all or a portion of nonfinancial equity investments.

<sup>4</sup> On December 4, 2007, the FASB issued Statement No. 160, "Noncontrolling Interests in Consolidated Financial Statements" (FAS 160). As a result, the noncontrolling interest (minority interest) will be reclassified from a liability or "mezzanine" item to equity, and reported in the consolidated statement of financial position within equity, separately from the parent's equity. FAS 160 will become effective for most entities with a calendar year-end on January 1, 2009. The proxy formula will be modified accordingly once this change in GAAP is implemented.



Restricted elements – Noncumulative perpetual preferred stock (including trust preferred securities and other hybrid investments) and minority interest. In the proxy calculation you should limit the amount of these investments to 25% of the tier 1 proxy capital amount (15% for large internationally active holding companies<sup>5</sup>). This limit should also include all minority interest except that related to qualifying common or noncumulative perpetual preferred stock directly issued by a consolidated U.S. depository institution or foreign bank subsidiary.

### Reaching a Conclusion on Capital Sufficiency

You must assess capital sufficiency on qualitative and quantitative factors. To determine whether the holding company's capital is sufficient, you should answer several questions:

- How do the different measures of capital compare and do they highlight any particular weakness?
- To what extent does the holding company rely on trust preferred securities or other hybrid equity securities as a source of financing? Did you include such securities as restricted elements in the regulatory proxy calculation? Is the amount of restricted elements approaching 25 percent of the regulatory proxy calculation? If you did not compute a regulatory proxy measure, you should closely scrutinize any holding company that has trust preferred securities, or similar hybrid instruments with both debt and equity characteristics, that approach 25 percent of the holding company's tangible capital.
- Does the holding company have a high proportion of assets that a thrift would be unable to count as capital?
- Does the holding company have the ability to raise new equity capital or generate capital internally, through earnings other than from the thrift?
- Has the holding company's capital position deteriorated since the last examination, and if so, why?
- Have significant asset/liability restructurings, acquisitions, or divestitures occurred?

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<sup>5</sup> An internationally active holding company is defined as one that has 1) total consolidated assets equal to \$250 Billion or more or 2) on a consolidated basis reports total on-balance-sheet foreign exposure of \$10 Billion or more. The 15% limit increases to 25% for trust preferred securities that mandatorily convert into an equity instrument within a short period.

As you review capital, there are some positive factors that enhance capital protection. These include:

- Strong management that has a record of superior capital management;
- Sound asset quality; and
- A history of strong, consistent, and recurring operating earnings and cash flow.

Similarly, potential adverse factors that detract from the holding company's capital condition include:

- Demonstrably weak or ineffective management;
- Poor asset quality;
- A history of weak earnings or reliance on nonrecurring earnings;
- Low liquidity, high interest rate risk exposure, or high foreign exchange exposure;
- Significant levels of off-balance sheet activities, including asset securitization activities, which can result in the retention of substantial recourse;
- Reliance on wholesale and short-term funding sources, or a significant amount of longer-term debt that will mature soon;
- Engaging in higher risk activities, unless adequately hedged and well-managed;
- Internal inability to generate sufficient capital because asset growth exceeds sustainable equity capital formation;
- No, or limited, access to capital markets; and
- Excessive capital distributions paid to, or the divestiture of subsidiaries to, stockholders.

## DIVIDENDS

Dividends are the primary way that organizations provide return to shareholders on their investment. During profitable periods, dividends represent a return of a portion of an organization's net earnings to its shareholders. During less profitable periods, dividend rates are often reduced or sometimes eliminated. The payment of cash dividends that are not fully covered by earnings, in effect, represents the return of a portion of an organization's capital at a time when circumstances may indicate instead the need to strengthen capital and concentrate financial resources on resolving the organization's problems.

The dividend practices of the holding company may affect the financial position of its thrift and other subsidiaries. Dividend policy influences the sustainable growth rate of any organization based on its effect on retained internal capital.

You should determine if the holding company's dividend payout and prospective rate of earnings retention are consistent with its capital needs, asset quality, growth, cash flow, and overall financial condition. You may calculate the dividend payout ratios for the parent and any holding company subsidiaries.

$$\text{Dividend Payout Ratio} = \frac{\text{Dividends Paid}}{\text{Net Income}}$$

The holding company's dividend payout ratio should be reasonable and consistent with its existing business plan. You should compare the dividend payout ratio, net income, and asset growth of each significant affiliate of the holding company. When analyzing holding company dividends the following guidance applies:

- Sustainable core earnings should suffice to pay the dividend over the long term.
- There should be adequate liquid assets on hand to make dividend payments.
- Generally, a holding company and its thrift should avoid borrowing funds for stock repurchases, or to provide for the payment of dividends to shareholders of the holding company. (Management may propose this when it wants to avoid the negative market reaction that may result if it cuts the dividend. Similarly, the company may need borrowing if its cash flows are seasonal, such as a retailer heavily dependent on holiday sales.)
- Neither the holding company nor the thrift should have to sell assets to provide funds for the payment of dividends to the holding company's shareholders.
- The prospective rate of earnings retention should be consistent with the organization's capital needs, asset quality, and overall financial condition. Dividends should not be paid if there is a reasonable expectation that the capital will be needed to support the subsidiary thrift or to cover losses, deteriorating asset quality, or downturns in the economy.

The inability to sustain or increase stockholders' dividends may demonstrate holding company weaknesses. Often, the suspension of dividends results from a shortage of liquidity. Even the perception of the holding company running low on cash can lead to repercussions for its subsidiaries. When the thrift subsidiary's public identity links to the holding company, a crisis or loss of confidence in the holding company could adversely affect the subsidiary regardless of its financial stability. For example, consumers not familiar with the distinction between the thrift and its parent may withdraw deposits if there is the perception that the holding company is running out of cash. To avoid loss of market confidence, a thrift may face pressure to provide extra support to a holding company or affiliate to avoid a crisis.

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## CAPITAL MANAGEMENT AND OVERSIGHT

Strong capital management is a positive qualitative factor affecting the adequacy of capital. Managers and directors should anticipate capital needs and maintain adequate capitalization. Holding company management should develop a capital management plan if the holding company's ratios are low or fluctuating relative to others with similar risk profiles in its industry. A good plan outlines management's specific strategies to reach its established goals.

Most financial organizations consider several factors in evaluating capital adequacy. These include:

- Peer comparison of capital ratios;
- Risk concentrations in credit and other activities;
- Current and desired credit-agency ratings; and
- Historical experiences, including severe adverse events.

Many holding companies and other financial organizations use stress testing and scenario analysis as tools to estimate unexpected losses. This helps organizations project the performance of their assets under conservative "stress test" scenarios. Stress testing can estimate the portfolio exposure to deteriorating economic, market, and business conditions. It also allows management to input different assumptions and thereby foresee potential consequences.

Holding companies should demonstrate sound capital and risk management. One method of demonstrating this is to meet an objective measure of financial health, such as a target public-agency debt rating or a statistically measured maximum probability of becoming insolvent over a given time horizon. This latter method is the foundation of the Basel Framework's treatment of capital requirements for market and foreign-exchange risk. Risk assessment must address all relevant risks including credit risk, market risk, liquidity risk, interest rate risk, operational risk, legal risk, and others.

You should criticize a holding company without adequate procedures to estimate and document the level of capital necessary to support its activities.

You should interview holding company management to identify its plans for ensuring a safe cushion of capital. During your conversations, you also should emphasize that the holding company's level of capital is a major consideration in the overall examination rating. Specifically, you should inquire whether it plans:

- New debt issues or sales of equity;
- Additional capital contributions;
- Loans, transfers, or distributions of holding company assets within the holding company structure; or

- Acquisitions.

## RATING THE CAPITAL COMPONENT

To properly assess risk at the holding company, you must consider the thrift subsidiary, the nonbank subsidiaries, the parent only and the consolidated entity. You should consider capital on a consolidated basis because holding company management has some discretion for the allocation of capital within the organization. It may also be useful to consider capital after deducting thrift capital. For holding companies with functionally regulated subsidiaries, you should also analyze capital after deducting capital held within such functionally regulated subsidiaries.

Evaluate capital sufficiency, on a case-by-case basis, considering among other things, the holding company's documented analysis of the capital it needs to support its activities. Capital levels should be risk sensitive.

Further, all the holding company examination components are integral to the overall examination process. For example, your findings about earnings will have an impact on your conclusions about capital adequacy.

The capital rating reflects the adequacy of an enterprise's consolidated capital position, from a regulatory perspective and an economic capital perspective, as appropriate to the holding company enterprise. During your review of capital adequacy, you should consider the risk inherent in an enterprise's activities and the ability of capital to absorb unanticipated losses, to provide a base for growth, and to support the level and composition of the parent company and subsidiaries' debt. The capital rating is based on the following rating definitions:

- **Capital Rating 1.** A rating of 1 indicates that the consolidated holding company enterprise maintains a more than sufficient amount of capital to support the volume and risk characteristics of its business lines and products; to provide a significant cushion to absorb unanticipated losses; and to fully support the level and composition of borrowing. In addition, the enterprise has more than sufficient capital to support its business plans and strategies, it has the ability to enter capital markets to raise additional capital as necessary, and it has a strong capital allocation and planning process.
- **Capital Rating 2.** A rating of 2 indicates that the consolidated holding company enterprise maintains sufficient capital to support the volume and risk characteristics of its business lines and products; to provide a sufficient cushion to absorb unanticipated losses; and to support the level and composition of borrowing. In addition, the enterprise has sufficient capital to support its business plans and strategies, it has the ability to enter capital markets to raise additional capital when necessary, and it has a satisfactory capital allocation and planning process.
- **Capital Rating 3.** A rating of 3 indicates that the consolidated holding company enterprise may not maintain sufficient capital to support the volume and risk characteristics of certain business lines and products; the unanticipated losses arising from the activities; or the level and composi-

tion of borrowing. In addition, the enterprise may not maintain a sufficient capital position to support its business plans and strategies, it may not have the ability to enter into capital markets to raise additional capital as necessary, or it may not have a sufficient capital allocation and planning process. The capital position of the consolidated holding company enterprise could quickly become insufficient if there is deterioration in operations.

- **Capital Rating 4.** A rating of 4 indicates that the capital level of the consolidated holding company enterprise is significantly below the amount needed to ensure support for the volume and risk characteristics of certain business lines and products; the unanticipated losses arising from activities; and the level and composition of borrowing. In addition, the weaknesses in the capital position prevent the enterprise from supporting its business plans and strategies, it may not have the ability to enter into capital markets to raise additional capital as necessary, or it has a weak capital allocation or planning process.
- **Capital Rating 5.** A rating of 5 indicates that the level of capital of the consolidated holding company enterprise is critically deficient. Immediate assistance from shareholders or other external sources of financial support is required.

## SUMMARY

The capital sufficiency of a holding company is a critical factor in the regulation of thrift holding companies. You must consider the:

- Necessary capital based on the risk exposure of each holding company and nonbank subsidiary activity;
- Relationship between debt, hybrid instruments, and capital;
- Existence of long-term debt in the capital structure;
- Extent and use of debt at the parent to fund capital investments of subsidiaries;
- Trend of capital in comparison to peer groups;
- Ability of management to devise capital plans for capital deficiencies or planned expansions;
- Ability to access the capital markets;
- Extent of concentration in any one asset or type of asset, including intangibles, interest only (I/O) strips, illiquid assets, and deferred tax assets; and
- Extent of off-balance sheet exposure.

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## HYBRID INSTRUMENTS

Hybrid capital instruments have characteristics of both common stock and unsecured debt. They resemble debt because they generally pay a fixed or floating interest rate, coupon, or dividend. At the same time, these securities are deeply subordinated, often have long maturities, and may be similar to common equity in their ability to absorb losses. Banking organizations in the United States rely on hybrid capital instruments and other innovative instruments for capital funding. Sources of hybrid capital funding are continually evolving. These sources of funding, especially if double leveraged,<sup>1</sup> can increase an institution's risk profile by generating substantial pressure to maintain earnings to support dividend payments. An institution's over-reliance on double leverage will trigger increased supervisory scrutiny.

Advantages to issuers for considering hybrid instruments include a lower cost of capital, tax deductibility, regulatory and rating agency equity credit recognition, and diversity in funding source. However, the overuse of hybrid instruments could lead to increased levels of risk that warrant management's close attention. Risks may include increased leverage, a thinner capital base for the consolidated organization (including both the savings association and its holding company), increased interest rate risk, and increased funding and liquidity risks.

During the thrift and holding company examinations, as well as through ongoing supervisory monitoring, OTS will review capital levels and the ability to service debt both individually and on a consolidated basis. While hybrid capital instruments can help banking organizations manage their capital structure, OTS expects parent-infused Tier 1 capital to derive predominantly from voting common stock or retained earnings of its parent. In addition, OTS considers the following features as guiding principles when evaluating hybrid instruments: loss absorption ability, permanence of the instrument, ability to suspend dividend payments, and certainty in cost of funding.

Some of the more familiar types of hybrid capital instruments include trust preferred securities (TPS) and asset-driven securities, particularly real estate investment trust (REIT) preferred securities. There are also innovative hybrid instruments such as mandatory convertible preferred securities and enhanced trust preferred securities that have resulted from regulatory and rating agency changes.

### Trust Preferred Securities

Trust preferred securities are non-perpetual cumulative preferred securities. In most cases, the holding company establishes a special purpose entity (SPE), usually in the form of a trust, to issue the securities. The SPE issues preferred securities to outside investors. With the proceeds, the SPE purchases an equivalent amount of junior subordinated debentures with stated maturities from the holding company. The subordinated note, which is senior only to a holding company's common and preferred stock, has terms that generally mirror those of trust preferred securities, except that the subordinated note often has a fixed maturity of at least 30 years.

Generally, the terms of the trust preferred securities allow the trust to defer dividends for at least a twenty-consecutive-quarter period without creating an event of default or acceleration. If the trust fails to pay the

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<sup>1</sup> For a source of capital, savings associations sometimes rely on debt the holding company issues. Double leverage exists when a holding company invests funds it obtains from debt proceeds into the savings association as equity. Increasing the capital base allows the savings association to increase its borrowings as well, thereby compounding the original holding company debt resulting in higher consolidated leverage.

cumulative dividend after this period, default occurs, and the principal and interest on the note becomes immediately due and payable. Dividends paid on trust preferred securities are a tax deductible interest expense thus representing a key advantage for holding companies.

Pooled issuances of trust preferred securities typically involve thirty or more separate holding company issuers and have made the issuance of trust preferred securities possible for small holding companies, most of which did not previously have this form of capital market access.

### Real Estate Investment Trust (REIT) Preferred Securities

Subordinate organizations of the savings association often issue REIT preferred securities. A thrift-controlled REIT issues noncumulative perpetual preferred securities into the market and uses the proceeds to buy mortgages and mortgage-backed securities from its majority common shareholder, its parent institution. A SPE must qualify under federal tax laws to be a REIT. The two main qualifications for a REIT are that it must (a) hold predominantly real estate assets and (b) annually pay out a substantial portion of its income to investors. The benefit of qualifying as a REIT is that its income is not subject to an entity-level tax. Rather, taxation occurs at the investor level.

In a typical structure where the thrift controls a REIT, the REIT subsidiary preferred securities, in general, could qualify for inclusion in Tier 1 capital as minority interests in a consolidated subsidiary subject to certain prudential standards. The terms and conditions include but are not limited to a capital limitation and a convertibility provision. Preferred securities may constitute no more than 25 percent of a savings association's Tier 1 capital. In addition, the convertibility provision allows the thrift to exchange noncumulative REIT preferred securities directly for issued noncumulative perpetual preferred securities of the parent institution upon the occurrence of certain events, such as the institution becoming undercapitalized, going into receivership, or at the direction of the regulator.

### Enhanced Trust Preferred Securities

Enhanced trust preferred securities have more equity characteristics than traditional trust preferred securities and receive equity credit from credit-rating agencies. Revised rating agency guidelines that allow partial equity credit treatment of these securities has driven the growth of enhanced trust preferred securities. Enhanced trust preferred securities differ from traditional trust preferred securities in several ways:

- A longer maturity of 60-80 years versus 30 years;
- A longer deferral period of ten years versus five years;
- Inclusion of replacement capital covenant (similar hybrid security needs to be issued to replace an existing hybrid in the event of redemption); and
- Alternative payment mechanism (permits issuer to settle omitted coupon payments in cash via the market issuance of securities, or by giving the hybrid holder equity-like securities).



### Mandatory convertible preferred securities

Mandatory convertible preferred securities involve the joint issuance by a holding company to investors of trust preferred securities and a forward purchase contract. The forward contract obligates the investors to purchase a fixed amount of the holding company's common stock, generally in three to five years.